Internal Revenue Service
memorandum

CC:INTL-724-89
Br5:BFelker

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to: Dave Reinig, International Examiner, Dallas

from: Bob Katcher, Chief, CC:INTL:Br 5

subject: Translation of Foreign Taxes under old Section 960

This memorandum is in response to your request for informal technical assistance on the pre-1987 translation rule for crediting foreign taxes paid by a lower-tier CFC when a dividend distribution of the associated lower-tier earnings results in a subpart F inclusion from the upper-tier CFC. For the reasons set forth below, the lower-tier taxes should be translated into the functional currency of the upper tier at the spot rate on the distribution date and translated into dollars for purposes of section 960 as if the lower-tier taxes were paid by the upper-tier CFC on that date.

Assume US owns all the stock of CFC1, a Netherlands corporation, which in turn owns all the stock of CFC2, a French corporation. CFC2 earns 150 francs of nonsubpart F income and pays 50 francs of tax, resulting in 100 francs of E&P. CFC2 distributes 100 francs to CFC1. The franc dividend is subpart F income of CFC1 taxable to US, which is entitled to a credit for foreign taxes deemed paid under section 960.

The 100 franc dividend is translated into guilders at the spot rate on the distribution date under § 1.301-1 (b). CFC1 converts its guilder E&P into dollars and computes its subpart F income under § 1.964-1 (a) - (e). In addition, any guilder corporate income taxes or franc withholding taxes paid by CFC1 with respect to the receipt of the franc dividend are translated into dollars at a historic rate for purposes of the section 960 credit. GCM 37133.

Section 1.960-2 (b) provides that for purposes of §§ 1.960-2 (a) and 1.960-1 (c) (1) (i), section 902 (b) applies to a dividend received by an upper-tier CFC from a foreign corporation. Accordingly, under the Bon Ami rule applicable in translating taxes for purposes of section 902 the franc taxes should be translated into guilders at the spot rate on the distribution date. In effect, the franc taxes are treated as "paid" by CFC1 on the date the franc dividend is received. The translated taxes are then translated into dollars for purposes of section 960 at the appropriate dollar-guilder exchange rate. Cf. Temp. Reg. § 1.905-5T (b) (1) (1988), providing that in the case of a redetermination taxes deemed paid by a taxpayer under section 960 in pre-1987 years are translated into dollars at the rate of exchange for the date of payment of the foreign tax.

We considered whether it might be appropriate to translate the franc taxes into dollars at the exchange rate applicable when CFC2 actually paid the taxes, rather than at the time CFC1 is deemed to have paid them. However, this approach would presumably require segregation of the associated franc earnings at the CFC1 level, which is inconsistent with the requirement that CFC1's E&P be computed under domestic principles. As a practical matter, the franc E&P distributed to CFC1 cannot be segregated as franc E&P as it is distributed through tiers, but must be translated into guilders at the time it is included in the E&P of CFC1. Translation of the franc taxes into guilders at the same time is necessary to preserve the proportionate relationship between the earnings and taxes required by Bon Ami if the earnings were included in income only upon an actual distribution to US.

Accordingly, the more consistent rule for the case at hand would be to translate the franc taxes into guilders at the spot rate on the date the dividend is distributed to CFC1 and to apply the section 960 guilder-dollar translation rule when the earnings are deemed distributed to US from CFC1. If you have further questions on this subject, please call Barbara Felker at FTS 566-6284.

cc: Val J. Albright, Dallas Regional Counsel